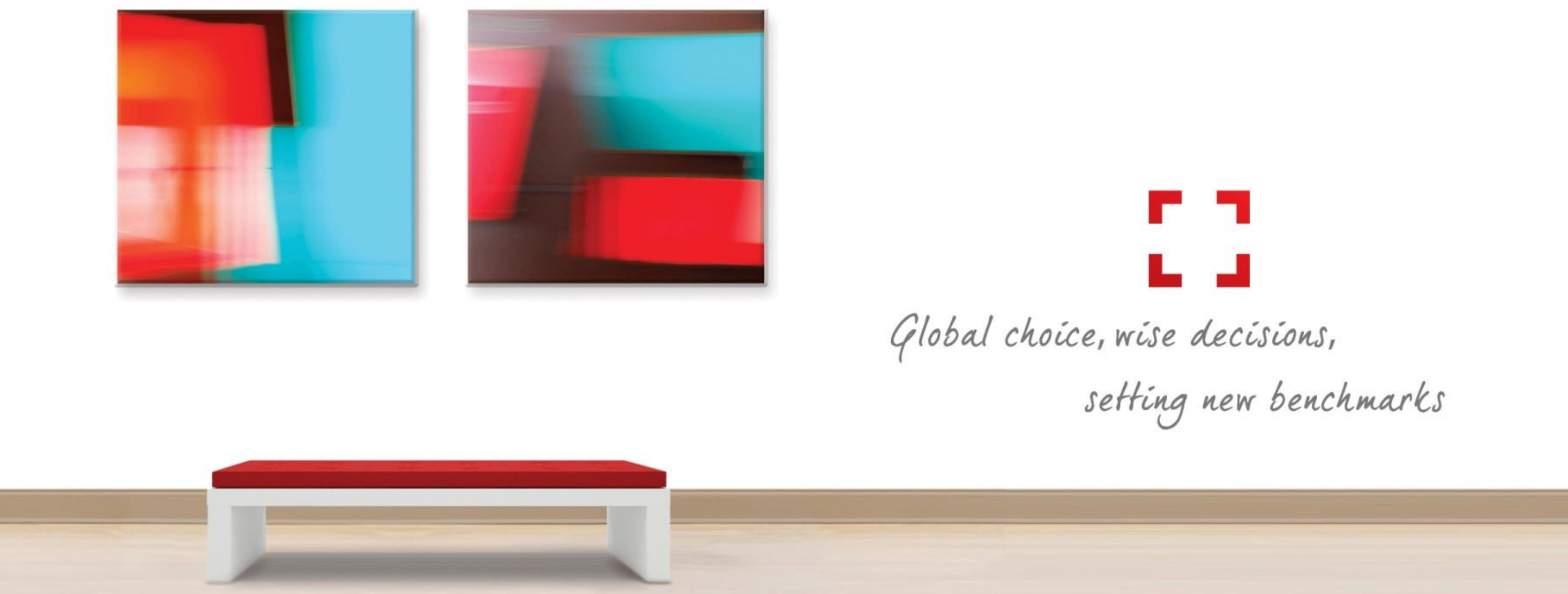
momentum

The future of fund platforms: CP12/12 explained

Prepared by

Russell Andrews

April 2013



global investment management

Contents

1. Introduction

In November 2011 Momentum Global Investment Management ('Momentum') produced the research paper 'thinking about the future of fund platforms'. The 2011 research paper discussed the rise of fund platforms, described the various types of platforms and gave an early prediction of what Momentum saw as the potential challenges fund platforms may face in light of the FSA's Retail Distribution Review (RDR) and associated policy changes.

At the time of writing the 2011 research paper, the FSA had given a strong indication in their policy statement released in August 2011 (PS11/9) that the attempted reformation of the UK retail investment market was to look beyond the role of the adviser and move along the value chain to the platform.

In June 2012, the FSA published consultation paper CP 12/12 which confirmed their plans to implement a ban on all commissions paid by product providers to platforms on advised and non-advised business, along with the ban of all cash rebates paid by product providers directly to consumers.

After three months of industry feedback, the FSA closed CP12/12 for further responses in September 2012 with a view to issuing the final platform paper by the end of 2012. However, after significant lobbying from the industry, particularly the major platforms including Skandia and CoFunds, the final publication has been delayed to Q2 2013 and is anticipated in early May after ratification at the April FSA Board Meeting.

The theoretical rationale behind the CP12/12 is fairly simple; 1) to clarify the role of the platform to the consumer / adviser and 2) extend transparency with respect to the cost of investing for the end consumer, whether advised or non-advised. The latter was clearly a focal point of the RDR and resulted in a ban on all commissions payable to advisers.

In the same way that the RDR has resulted in the need for wholesale changes to many advisers' business models, CP12/12 is likely to have the same result for most if not all platforms.

The purpose of this report is to give a view of what we believe CP12/12 might end up including, explore what this will do to the landscape of the UK platform industry and explore how this will ultimately impact each element of the value chain, including the end consumer, adviser, platform and the product provider.

2. What is the FSA platform paper (CP12/12)?

The initial communication from the FSA (PS11/9) in August 2011 set the scene as to how it wanted to supplement the RDR with regulation relating to platforms. In the same way that the RDR was designed to provide clarity and better governance of the services provided by advisers to the retail consumer, the FSA wanted regulation to govern the charging structure of platforms, the relationship between platforms and product providers and create a better understanding of how platforms are positioned in the UK retail market.

What is a platform?

The FSA is keen to provide clarity to the consumer as to what a fund platform is. In CP12/12 they state that platforms

> "primarily provide a service to the end consumer and the end consumer usually pays for this service through the product charge".

This statement makes it clear that the FSA views platforms as a provider of wrapped investment products, investment portfolio administration, and professional dealing services with detailed reporting to the retail investor.

Additional services provided such as portfolio modelling tools, tax calculators, investment research reports are seen as non-core services by the FSA.

Fees

In light of this perception, the FSA's objective is to ensure that in the same way the RDR has resulted in advisers charging an explicit fee for their services, platforms do the same. They view the target charging model in the same way that a consumer would pay for other non-financial services such as building or utility services. For example, a builder will charge a consumer for the direct services provided and not offset those charges against commissions received from the company supplying the bricks. With this in mind, the FSA intends to ban commission payments from product providers to platforms ensuring transparent charging and maintaining fairness to the consumer.

> *CP12/12 – section 2.2*
>
> *"Advisers, platforms and fund managers all provide a distinct service to the end consumer. Our view is that each of these services should be priced to reflect the work being carried out for the consumer, rather than being priced at a level that often bears little relation to the cost of providing that service."*
>
> *Financial Services Authority, 2012*

The FSA views this as a particularly important change to the way that consumers of non-advised platforms are charged and how those services are marketed. This is because, historically, many non-advised or execution only platforms have marketed themselves on the basis that they are 'free' to the consumer. However in reality, they have been receiving as much as 1% per annum in commission from product providers, which is deducted from the consumer's investment throughout the year. Quite often a portion of the commission is passed on to the consumer, but a number of platforms use the commission to cover the cost of their operation. This model offers little to no transparency to the consumer, who may as a result of the model be invested in a more expensive fund or shareclass on the basis that it has a the higher fee and the most scope for platform commissions.

So what is a fair price?

This is difficult to ascertain. Until now platforms may not have fully assessed their charges versus the services they provide because of the revenue generated by commissions; however, this will soon have to change.

There will naturally be a variety of differing products and services provided by platforms, along with greater tools and bigger brands. At Momentum we believe that the eventual standard platform charges will vary between 0.05% and 0.25% per annum, with the option of transactional based fees. These fees will be paid directly by the consumer and whilst potentially paid using proceeds from periodic disinvestments, they will not be influenced by commissions paid by the product provider.

Competition

As a by-product of increased transparency, the FSA believes that the unbundling of the cost of investing and the implementation of explicit charging will promote better competition in the retail market.

Advisers and consumers will be able to easily assess the full cost of a platform versus another platform, when historically this has been almost impossible to do accurately, with or without expensive software of experienced resources.

As well as the platforms, once fees are unbundled, the products themselves will also be more easily compared by their cost. This is because all products should contain a clean shareclass with no additional fees built in to remunerate platforms; the Annual Management Charge (AMC) will be 100% paid and retained by the product provider/investment manager.

Rebates to consumers

In addition to increasing the transparency of the cost of platforms, the FSA is also looking to ban the payment of cash rebates from product providers to consumers. It is felt that the payment of these cash rebates may influence a consumer's decision to invest via a particular platform, allowing for the effective continuation of platform rebates through increased platform fees, and does not provide for the intended level of transparency.

The FSA have confirmed that they have no immediate concerns with the principle of rebates between product providers and consumers, as they benefit the consumer. However, the FSA insists that rebates should only be available in the form of additional shares in the invested fund, held on the platform for the benefit of the consumer.

From the perspective of the platform, this is an area of much contention. Many platforms and observers see the negotiation of cash rebates for the direct benefit of the consumer as an integral part of their proposition and whilst they can continue to offer such benefits they will be in the form of shares. This move will require significant changes to processes, controls and technology at the platform, for sums that may ultimately be very small. In light of this, recent reports suggest that the FSA are considering allowing the continuation of cash rebates under £1, which should reduce the impact of the ban and allow for the retention of developed efficiencies.

Timing

When the final version of CP12/12 is published during the spring of 2013, the 12 month implementation timeframe that was offered by the FSA in CP12/12 will remain therefore full implementation is not likely until the spring of 2014. Also, in the same way that the RDR only applies to assets invested or advised post 31 December 2012, the new platform regulation will equally apply only to assets invested or switched between investments after the full implementation date.

In some respects this allows platforms to protect revenues from legacy assets, but in order to do this they will be required to run two distinct business models.

3. UK platform industry

So what might these changes mean to the UK platform landscape?

As highlighted in Momentum's 2011 research paper, the UK platform industry has grown substantially over recent years and since 2011 this trend has continued at an even greater pace. Since early 2011 the advised assets under platform administration increased from just over £160bn to close to £225bn at the start of 2013. With this growth in assets under administration (AUA), and what appears to have been a relative stabilisation of system and product developments, more platforms than ever are now turning a profit. The most notable of these being the UK platform giant CoFunds who sit at the top of the platform AUA charts with *c.* £52bn.

Margin compression

In light of the elimination of commissions from product providers, platforms will need to structure charging on an explicit basis. In doing this, and providing the necessary analysis is completed, it will become apparent how much platforms will need to charge consumers for the services they provide. The greater level of transparency and a new charging model will require platforms to re-negotiate terms with their clients, where direct charging doesn't exist or is supplemented by product provider commissions. This change will undoubtedly result in challenge from some clients, particularly those with greater assets and significant leverage. As with many service industries where choice exists, fees will be driven down and margins squeezed.

Segmentation

With a squeeze on margins and a model that doesn't allow for larger clients to unknowingly supplement smaller clients, platforms may see the greater need to segment their clients and create different service propositions depending on the segment in question. This exercise is something that the adviser market is slowly coming to terms with as a result of the RDR. The need for explicit charging will most likely prevent advisers offering their full advice and implementation service to clients with assets under £250k, and potentially no service at all to those with less than £50k, creating orphan clients. Platforms may have to follow the same path in order to eliminate the clients that cost money rather then generate revenue.

One possible mitigating action could be the introduction of minimum annual charges, which is a topic never easy to communicate. Ironically, this is something that certain platforms have historically built into contracts with product providers to protect against those providers who failed to raise enough assets to generate the level of annual commission that satisfied their requirements.

How many models one, two or three?

With the RDR effective 31 December 2012 and the platform regulations (CP12/12) likely to 'go live' in Q2 2014, the reality for some platforms could be that they may be forced to operate three separate business models. Model 1: pre-RDR model which uses bundled shareclasses and allows for adviser rebates, consumer rebates (cash or units) and platform commissions; Model 2: post-RDR yet pre CP12/12 using semi-bundled shareclasses where consumer rebates and platform commissions are permitted; and Model 3: clean shareclasses with no rebates or commissions or semi-bundled shareclasses with consumer unit rebates.

Fundamentally, this approach would pose any business with the obvious challenge of maintaining efficiencies, particularly if those efficiencies have only recently been realised. In addition, it is likely to present the platform with issues around effective and consistent communication as it is highly likely that the platform will have clients who span all three models. Over time, assets held in 'Model 1' will naturally dwindle but establishing how quickly this may happen will be an important part of the segmentation process.

Any platform that takes the decision to apply a single 'new world' view (because their existing business model is sustainable without rebates or commissions) must then establish how they complete the transition with as little impact to the client as possible. How they achieve this remains a mystery to most if not all and is likely to provide the biggest challenge the UK platform industry has ever faced.

Participant consolidation

As more and more advisers write new business on platforms and the online direct to consumer market expands, we anticipate platform AUA to continue to increase. However, when considering that the top seven platforms command *c.75*% of AUA (*c*. £175m), this growth will no doubt be focused in these areas. Opportunist market entrants should not be discounted, such as Aviva (which is actually a market re-entrant), Aegon and Zurich, which have the brand, budget and broad client base to impress and attract business.

So where does this leave the smaller platforms? In our 2011 research paper we made reference to the likely consolidation of the number of market participants; this view has not changed. If anything, the implications of CP12/12 may accelerate this exercise as platforms elect to close to new business to avoid the burdensome and expensive developments, or become available to their larger competitors for an acquisition.

Despite the organic growth expectations, a single or multiple acquisition strategy may be something that the likes of CoFunds, Skandia or Fidelity could consider. This is because scale will become even more important, as the minimum asset level to breakeven is likely to increase as fees are squeezed and the cost of compliance, and the transition to compliance, becomes a reality.

Today's UK adviser platform market includes more than thirty players but over time we believe this will reduce to between ten and fifteen.

4. The broader market impact

Advisers

CP12/12 has not been designed to have a direct impact on the adviser community, but inevitably it will create some knock on effects as platforms re-define their models. The most pertinent change as a result of the paper will be the future charging structure for platform services as platforms establish new fee terms with the regards to consumer assets. In many circumstances these will be arranged through the adviser. The explicit platform fee, which had previously been bundled with the product charges and potentially unknown, will need careful explanation to the consumer and could result in pressure on the adviser to reduce their fees accordingly.

In the longer term, advisers will also have to deal with the potential headache of moving platform due to closure or establishing new relationships and terms, as platforms consolidate. There is no doubt that this exercise would be transitioned with as little incident as possible, but as an area of investment administration that remains inefficient, this may be easier said than done.

Product providers

To a far lesser extent, product providers will also face challenges around the operation of multiple models. However, these will be focussed on the payment of management fee rebates, which is usually a relatively small part of the investment management business model.

Over the years, product providers will have entered into multiple rebate arrangements with advisers and platforms. Whilst the RDR has eliminated the option of paying rebates to advisers on assets invested after 31 December 2012 and CP12/12 will do the same for rebates currently paid to the platform or cash rebates to the consumer (via the platform) during the spring/summer of 2014, those recipients will no doubt look to retain the rebate related revenue stream for as long as possible.

These scenarios will most likely be handled using different shareclasses of a single investment fund, which will include bundled shareclasses (allowing for adviser and platform rebates), semi-bundled classes (also known as commission free, that allow for platform rebates only) and clean shareclasses (that are fully unbundled, with an explicit investment management fee only).

The administration of three different fee sharing models will be challenging for product providers and will need to be handled carefully to avoid errors. Whilst this is certainly achievable, it is likely to require expert technology, additional resource, or both, a cost that could significantly erode profit margins.
In addition to the administrative impact, product providers are unlikely to escape the squeeze on fees that are expected on the rest of the value chain. This is likely to be driven by advisers who, when designing their own fee structures, will no doubt be considering the total fee experience for their client, for which the product forms an integral and now transparent part.

On a positive note for product providers, particularly those with greater scale, in-house administration services or additional insurance licenses, CP12/12 could present an opportunity to design cost effective implementation services that rival platforms. Setting up a Discretionary Fund Management (DFM) service which includes administration services may be something more aligned with restricted advisers, but like others market observers, Momentum anticipates restricted advice to form the larger share of the advised retail investment market over time as RDR takes hold.

In addition to the above, the rebate ban and the increase in competition will potentially make it easier for smaller product providers to not only stand out against their larger competitors, but also to access distribution as it will not be something that can be simply purchased via expensive platform inducements.

Consumers

The ban in platform commissions and the resulting transparency is certainly good news for the end consumer, and there is little to no doubt that the FSA's overhaul of the advised retail investment market via the RDR and the CP12/12 is derived from good intentions. However, the one question that exists right now and is likely to remain for some time is "at what cost?"

5. Conclusion

Whilst there is little doubt that the intentions of the FSA are good and in the long term both the RDR and CP12/12 will create a better environment for retail investing, there is also little doubt the state of flux expected in the short to medium term will create some winners and many losers across the whole industry.

Who ends up in which category is something that only time will tell.

Important notes

Momentum Global Investment Management is the trading name for Momentum Global Investment Management Limited. This document does not constitute an offer or solicitation to any person in any jurisdiction in which it is not authorised or permitted, or to anyone who would be an unlawful recipient, and is only intended for use by original recipients and addressees. The original recipient is solely responsible for any actions in further distributing this document, and should be satisfied in doing so that there is no breach of local legislation or regulation. The information is intended solely for use by our clients or prospective clients, and should not be reproduced or distributed except via original recipients acting as professional intermediaries. This document is not for distribution in the United States.

Prospective investors should inform themselves and if need be take appropriate advice regarding applicable legal, taxation and exchange control regulations in countries of their citizenship, residence or domicile which may be relevant to the acquisition, holding, transfer, redemption or disposal of any investments herein solicited.

Any opinions expressed herein are those at the date this material is issued. Data, models and other statistics are sourced from our own records, unless otherwise stated herein. We believe that the information contained is from reliable sources, but we do not guarantee the relevance, accuracy or completeness thereof. Unless otherwise provided under UK law, Momentum Global Investment does not accept liability for irrelevant, inaccurate or incomplete information contained, or for the correctness of opinions expressed.

We caution that the value of investments in discretionary accounts, and the income derived, may fluctuate and it is possible that an investor may incur losses, including a loss of the principal invested. Past performance is not generally indicative of future performance. Investors whose reference currency differs from that in which the underlying assets are invested may be subject to exchange rate movements that alter the value of their investments.

Our investment mandates in alternative strategies and hedge funds permit us to invest in unregulated funds that may be highly volatile. Although alternative strategies funds will seek to follow a wide diversification policy, these funds may be subject to sudden and/or large falls in value. The illiquid nature of the underlying funds is such that alternative strategies funds deal infrequently and require longer notice periods for redemptions. These Investments are therefore not readily realisable. If an alternative strategies fund fails to perform, it may not be possible to realise the investment without further loss in value. These unregulated funds may engage in the short selling of securities or may use a greater degree of gearing than is permitted for regulated funds (including the ability to borrow for a leverage strategy). A relatively small price movement may result in a disproportionately large movement in the investment value. The purpose of gearing is to achieve higher returns associated with larger investment exposures, but has concomitant exposure to loss if positive performance is not achieved. Reliable information about the value of an investment in an alternative strategies fund may not be available (other than at the fund’s infrequent valuation points).

Under our multi-management arrangements, we selectively appoint underlying sub-investment managers and funds to actively manage underlying asset holdings in the pursuit of achieving mandated performance objectives. Annual investment management fees are payable both to the multimanager and the manager of the underlying assets at rates contained in the offering documents of the relevant portfolios (and may involve performance fees where expressly indicated therein).

Momentum Global Investment Management Limited (Company Registration No. 3733094) registered office at 20 Gracechurch Street, London EC3V 0BG.

Momentum Global Investment Management Limited
is authorised and regulated by the Financial Services Authority in the United Kingdom, and is an authorised Financial Services Provider pursuant to the Financial Advisery and Intermediary Services Act 37 of 2002 in South Africa.